

Bi-Annual
AL-ADWA

June-2012 Vol. XXVII No. XXXVII

*Multilingual Research Journal
for
Islamic Social Sciences*



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UNIVERSITY OF THE PUNJAB
LAHORE-PAKISAN



An Analysis of Corporate Governance in Islamic and Western Perspectives

Part-1: Evolution of Companies

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1. Introduction:

A firm might be an association of persons, group of people, a limited or unlimited partnership, a company or corporation and several variants attached to each. However, the corporation is renowned by virtue of its distinct legal personality that is assigned by law, whereas partnership and unincorporated corporations have not. Company's shareholders own the company as a legal entity and the company as a legal person in turn owns the corporate assets. Every corporation as a separate legal entity from its shareholders has the same legal rights like an individual to enter into contractual arrangements, own property, sue and be sued in its own name rather than in the name of its shareholders. The rights and obligations of a person either legal person or natural person work side by side but some limited liabilities companies *shirkat al-'Inan* have different liabilities from unlimited companies *shirkat al-mufawadah* or partnerships. However, the historical development of corporate entity in British and Islamic systems can draw a clear picture for the analysis of prevailed concept around the world.

2. Historical Development of Company Law in British and Islamic Systems:

2.1. Companies in Islam:

In Islamic system of state (Khilafah), companies operate in pre-determined spheres of the economy because any utility designated by Islam regarded as indispensable for the community.(1) The utilities are regarded as public goods and therefore the revenue generated from utilities should be administered for the benefit of all citizens. The hadith of the Prophet (SAWS)"Muslims are partners in three things: in water, pastures and fire"(2) is regarded as a foundation-principle of utilities and public goods, where as the ownership of key utilities always remain with the state.(3) The prophet (SAWS) accorded his ascent to the practice of Shirkah as He said "I am the third with the two partners as long as they do not cheat one another but when one of the cheats, I leave them".(4) He also said that "Allah is with the two partners unless they defraud each other."(5) However, the extraction, development, refining or constructions are undertaken by companies who will be paid for such a contract.(6)

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In the time of the Islamic Golden Age (since mid 8th century till the invasion of Mongol in 13th century) early forms of capitalism through trade in free markets are found in Islamic State (Caliphate). The organisational enterprises were formed for trade and business, which were independent from state with the concept of agency that also exists in modern corporate era. The Islamic contract law around 10th century is assumed the classic form of business and corporate arrangement. The Roman Catholic Church during spilt of Christianity (1054) and the struggle to emancipate religion from the control of kings and feudal lords (1075-1122) began calling itself a corporation.(7) This struggle led to the rise of new canon law (*jus novum*) to deal with a wide range of issues including contract and corporate enactments for secular and ecclesiastical legal systems.

The demise of Roman Empire weakened the state central authority and led to the diverse private legal system as means of enhancing organisational efficiency by which the western corporation evolved. The main focus of Christianity was matters of faith, morality and community. However, the pre-existing legal system i.e. Roman law is followed by early Christians in their daily ordinary and business life. It is also argued that Roman law directly or indirectly influenced the development of Islamic corporate system.(8) Muslim scholars argue that Roman law was influenced by the Syrian and Egyptian local customs and those local customs were governed and influenced by the followers of the prophet Ismail (*AS*) the son of Ibrahim(*AS*) and those customs and usages prevailed in those tribes with the passage of time. It is essential principle of Islamic jurisprudence that previous laws are part and parcel of Islamic law. Secondly Islam has its own principles of Halal and haram and as per Islamic injunctions each and every transaction needs proper approval of the *Shariah*, thus all customs and usages are subject to the approval of the *Shariah*. There two possibilities: 1. Islamic system of trade /transaction was influenced by Roman law. 2. Islamic law accepted certain transactions with the approval of the Islamic injunction. In transitional period of Islamic era, the inhabitants of Middle East including Muslims who had the legacy of the Roman system practiced the Roman institutional heritage that also contributed towards the formation of European corporate system. The early Arab empires particularly Syrians and Egyptians studied and practiced the Roman law through local customs and usages. In Roman system, the Christian East laws regulate the internal affairs of Monasteries that were centrally formulated. Monasteries were explicitly merged to form large organisation for creating large centres of power.(9) However, Muslim communities gained exposure from the Roman culture either through business interaction with Roman traders or legal system of former Roman

territories. At the time of the Islamic conquests, corporate life was mostly limited to the Roman Middle East territories than Eastern Empires.(10) The Muslims jurists focused on organisational efficiency when classic Islamic legal system took place between 7th to 10th centuries with the possibility that they might have influenced by Roman traditional system under the approval of the Prophet (*SAWS*) as Islamic law demands that each and every positive/good thing is treasurer of the *mo'min*/muslim, where from he found has the right to use it.(11)

However, the start of Islamic era with the command of Prophet Muhammad (*SAWS*) led to the formation of Islamic legal system by modifying the existing customary laws of tribes that were immoral and against the Islamic principles rather abolition of previous system and practices as a whole. The Prophet (*SAWS*) established the norms of state and its political systems of governance. He had given an Islamic legal system to regulate the all sphere of life. Although the Islamic law is presumed comprehensive but it also provides elasticity for legislation to meet-out the needs of society rather than stick on divine law. However, the new legislation should be based on basic principle of Islamic law provided in the *Qur'an* and *Sunnah* of the Prophet (*SAWS*). Islamic law not only covers the personal affairs of the people but also many aspects of politics, economics, banking, business or contract law and other social issues.(12)

A Company (*Shirkah*) is regarded as an arrangement between two or more people to do some type of work in order to make profit and such profit is distributed among the contractual parties as dividend rather than salary. Islamic law defines *shirkat* or partnership in general as an underlying idea of mixing shares in such a way that one of them cannot be distinguished from the other. *Shirkah* has also been defined as a contract between two or more people for participation in a capital and its profit.”(13) The Islamic Law provides comprehensive frame work for contractual matters which are applied on companies. In Islamic system, the kinds of companies in contractual framework might be defined and classified in following manners:(14)

Shirkat al-'Uqood means two of more people come together making a contract for the investment of their capital and labour or reputation.

It is of three kinds:

- a) *Shirkat al-Amwal*(The Company of Capitals)
- b) *Shirkat al-A'mal* (The Company of Bodies)
- c) *Shirkat al-wujooh* (The Company of Reputations)

Each of the above is sub-divided into two categories i.e., 'Inan (limited) and mufawadah (unlimited).

A. *Shirkat al-Amwal*:

- i. Shirkat al-Amwal by way of mufawadah in which two or more partners invests a sum of money equally in a business with equal footing in their capabilities and share its profit and loss according to agreement and will be responsible for each other transactional acts.
- ii. Shirkat al-Amwal by way of 'Inan in which two partners invest their capital not necessarily with equal proportion of shares and run their business representing each other with no responsibility of loss.

B. *Shirkat al-A'mal or Shirkat al-Abdan* (The Company of Bodies or Labours):

- i. *Shirkat al-A'mal or Shirkat al-Abdan* by way of mufawadah in which two or more people come together with their skills such as consultants, doctors, engineers, craftsmen, lawyers and constitute the company with equal proportion of profit and loss and equal responsibility in business transactions.
- ii. *Shirkat al-A'mal or Shirkat al-Abdan* by way of 'Inan in which two or more people come together with their skills such as consultants, doctors, engineers, craftsmen, lawyers and constitute the company with different proportions of shares in profit and loss e.g., $\frac{1}{3}$ and $\frac{2}{3}$ or $\frac{1}{4}$ and $\frac{3}{4}$ or any negotiated settlement.

C. *Shirkat al-Wujooh* (The Company of reputation)

- i. *Shirkat al-Wujooh* by way of mufawadah (The Company of reputation) In this type of company, the capital is provided by silent partner and the reputation is used by the active partner both of them will be responsible/liable and having equal proportion of the profit and loss. The partners could be rich merchant having guarantee for payment of debts and the company is backed by the wealthy partners.
- ii. *Shirkat al-Wujooh* by way of 'Inan. In this type of business the capital is provided by the silent partners and reputation, standing and respect is used by the active partner having no responsibility/liability for each other and both of the partners having different proportions shares, profit and loss.(15)

2.2 Evolution of British system of Companies:

The Company or corporate governance is as old as the company or corporate form itself. During the 11th to 13th century associations of merchants called 'Merchant Guilds'. Guild means an association of merchants or crafts people in medieval Europe which was formed to provide counseling to its members and to formulate rules and regulation for trade. They obtained Charter from Crown to secure their members from practices of monopoly. Later on, this trading was known as 'Commenda' or 'Societas'.(16) These Guilds with the passage of time matured into family partnership and then partnership with outsiders. In 14th century, the word 'company' was adopted by certain merchants for trading overseas with

certain privileges by Royal Charter. During 17th century most of these companies started joint stock trade on their members' behalf and these companies also established fixed capital represented by shares which was freely saleable and transferable. At that time, company was incorporated only by Royal Charter or act of Parliament. The first two decades of 18th century witnessed the flood of fraudulent schemes of company flotation and the best example is South Sea Company and an associated company, the Sword Blade Company.(17)

In 1720, the Parliament came down to remedy the deception of investors through Bubble Act. The Act prohibited the use of corporation unless the corporation was authorized by Royal Charter or Act of Parliament but the Act exempted from its application to: 1) all the undertaking established before 24 June, 1718 and, 2) two companies founded by Act; South Sea Company and the East India Company. This particular Act provided the benefits of the South Sea Company in competition with the Bank of England but this company failed and its shares decreased ridiculously.(18) In this crisis, the estates of the directors were confiscated for the benefit of the company. The similarity is found between the recent corporate crises i.e. Enron and HIH Ltd, where several of the directors and officers were prosecuted and jailed. Although the Bubble Act 1720 made impossible for companies to raise further capital by invitations to the public for the next hundred years to 1825 (repeal of the Bubble Act) but it does not destroy the unincorporated companies which continuously formed and freely issued their transferable shares.(19)

In 19th century, two new developments occurred in British corporate law: first, the Joint Stock Companies Act 1844 was enacted- under which any company comprising more than twenty five members with transferable shares might obtain incorporation by registering a deed of settlement executed by its members. Secondly, the Limited liability Act 1855 was passed which provided limited liability of the members of a company.(20) The act was repealed by the Joint Stock Companies Act 1856 that allowed incorporation of the companies with limited liability and introduced the memorandum and articles of association by omitting the provisional registration and deed of settlement. During 1862 to 1907, a number of laws were passed that permitted the alteration of capital, the amendment of the memorandum and articles, as well as registration of private Companies. The Companies Consolidation Act 1908 gathered all the previous laws into single Act. The amendment of the law continued till the Act of 1907. In India, the company laws were introduced in 1850. This was followed by changes in 1857, 1866, 1887 till the law of 1913 which based upon the English Law of 1908. Changes made in this law in

1946 and these were based upon changes in the law of England.(21) However, the new Companies Act 1985 was introduced on the basis of previous statutory developments. The Directors' Liability Act of 1890 created the directors' liability to compensate all shareholders for damages suffered due to their untrue statements.²² The Insolvency Acts (1986, 1994 and 2000), the Company Directors Disqualification Act 1986, and the Enterprise Act 2002 also enacted to govern the insolvency, winding up and directors disqualification proceedings. Now the Companies Act 2006 is enacted that repealed the Companies Act 1985. New Companies Act 2006 is comprehensive in which already legal principle of common law through court decisions also incorporated and codified to bring clarity for business and corporate communities.

Conclusion:

The companies and corporate activities are as old as societies. The corporate and trade activities have direct concern on state economy. That is why; these activities were regulated under the supervision of state authorities rather than individuals themselves. The corporate norms of earlier societies and empires prevailed in the later societies with some modifications that were required with the passage of time. The Roman legal culture is influential in the development of western corporate system but the principles of Islamic law of contract are regarded as comprehensive business arrangements among the business communities and they laid down the basic principle of Islamic and western corporate law through partnership business in which companies are regarded as modern form of partnership or joint-stock companies.

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